

Saxo Academy

# Beginner's Guide to CFDs

Chapters 1.1 - 1.3

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CFD



## CFDs

### Chapter 1.1 / A Basic Description

Welcome to this chapter, which will give a brief introduction to the history of CFDs. If you are already familiar with the basics of CFDs, we recommend that you jump to the next chapters.

#### What is a CFD?

A contract for difference (CFD) allows you to trade a wide range of assets in both rising and falling markets. CFDs are designed to mirror the price of these underlying assets and to give you the ability to benefit from market movements without actually owning the underlying instrument.

A CFD is a financial contract between a client and a CFD provider. The 'difference' is the difference between the opening and closing price for the position. That difference is paid out in cash once the position has closed.

A CFD is therefore a derivative product where the CFD provider is the counterparty to the trade. Since the contract is not exchange-traded, the product is said to be OTC (over-the-counter). CFDs are traded on margin to give traders more trading power, flexibility and opportunity in the markets.

#### CFDs on Different Asset Classes

A wide range of asset classes can be traded via CFDs:

- Stocks (Apple Inc., Google Inc., Vodafone etc.)
- Stock Indices (DAX, SP500, FTSE100 etc)
- Commodities (Gold, Silver, Oil etc.)
- Forex (Major and Minor currencies)
- Bonds (Government Bonds)
- Exchange-traded funds and exchange-traded commodities (sectors, industries, regions etc.)

CFDs always relate to an underlying instrument with a reference price that is traded on an exchange.

So, in the case of a CFD on Apple, which is listed on Nasdaq Stock Exchange, the price of the CFD will track the price of the Apple stock in a 1:1 relationship. So for example, when trading a CFD on Apple Inc. listed on Nasdaq Stock Exchange, the price of the CFD will track the price of the Apple Inc. stock in a 1:1 relationship.

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## Overview of Characteristics

TYPE	TRADING COSTS (3)	MARGIN REQUIREMENT	EXPIRY	OVERNIGHT FINANCING	SHORTING SUPPORTED
Single Stocks	Commission	From 5.00%	No	Yes (1)	Yes (2)
Stock Indices	Spread	From 0.50%	No	Yes (1)	Yes (2)
Commodities	Spread	From 1.00%	Yes	No	Yes
Bonds	Spread	From 0.50%	Yes	No	Yes
Forex	Spread	From 0.50%	Yes	No	Yes
ETFs / ETCs	Commission	From 10.00%	No	Yes (1)	Yes (2)

- 1) Libor + mark-up/down
- 2) Shorting depends on availability in the market. Borrowing cost varies.
- 3) Minimum trade value and Minimum commission apply.

## CFDs Chapter 1.2 / Terminology

### Continuous vs Expiring Contracts

CFDs can be split into two broad categories based on the characteristics of their underlying instruments.

The first category consists of continuously traded contracts. These are CFDs that do not have an expiry date. They are typically CFDs on single stock, exchange-traded funds, exchange-traded commodities and most stock indices.

The second category consists of CFDs that do have an expiry date, which is similar to the expiry date of the underlying futures contract. These are typically CFDs on commodities,



forex and bonds. A CFD on crude oil will have a date as part of its instrument name, for example 'UK Crude June 2015'.

If you want to keep the exposure to the underlying asset after the CFD has expired, you would have to roll the contract over to the next maturity date.

For example, when trading a CFD on Crude Oil it will have a date as part of its Instrument name, e.g. "UK Crude June 2015". If you want to keep the exposure after the expiry date, you would have to roll the contract to the next maturity.

### Margin

CFDs are traded on margin. This means that you are able to leverage your investment by opening positions of larger size than the funds you have to place as margin collateral.

The margin is the amount reserved on your trading account to cover any potential losses from an open CFD position. It is possible that a loss may exceed the required margin.

Margin requirements vary from instrument to instrument and can be changed at any time to reflect market conditions.

Based on the market capitalization, liquidity and volatility of the underlying asset, a CFD will have a Rating which can be translated into the margin requirement for the contract. Please see table X for an illustration of different Ratings, Margin Requirements and Leverage...

RATING	MARGIN REQUIREMENT	LEVERAGE
1	0.5%	200:1
2	5%	20:1
3	10%	10:1
4	15%	6.67:1
5	25%	4:1
6	50%	2:1
7	75%	1.33:1
8	100%	0



## Shorting

Shorting, or taking a short position, means that you sell a CFD – without having bought it beforehand – in the anticipation that the price will drop in the future. If the price decreases and you close the position by buying it back, you would have made a profit.

On the other hand, if the price of the CFD increases, you would have to buy it back at a higher price than you sold it for, hence you would book a loss.

See Chapter 1.3 for an example of a taking a short position.

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## CFDs

### Chapter 1.3 / A Trading Example

#### Buying a Stock CFD - Taking a LONG Position

When you expect the price of a stock to go up, you can choose to take a long position in a single stock CFD.

In this example, you expect the share price of Company XYZ to rise from its current price of **£20.00**. You have £10,000 to place on margin. Since there is 20:1 leverage available on this instrument, you only have to place 5% of the trade amount on margin.

You decide to buy 1,000 CFDs at the offer price of £20.00, which gives you a position of (1,000\*£20.00) £20,000 in notional value.

Each day you hold the long position open, you pay a financing cost on the notional opening value of the position.

The annual interest rate used is LIBOR + Mark-up (0.50%+3.50% = 4.00%).

10 days later, the share price of Company XYZ has risen and you sell the 1,000 CFDs at **£21.50**.

Transaction	Transaction	Transaction (GBP)
<b>Opening the position:</b>		
Margin available	£10,000	10,000
Notional Transaction Value	1,000 x £20.00	20,000
Margin used	£20,000 x 5%	1,000
Commissions on the trade	£20,000 x 0.10%	20.00
Stamp Duty	n.a.	-
<b>Financing of position:</b>		
Financing of margin	4% x 10 days x £20,000 / 360	22.22
Borrowing costs	n.a.	-
<b>Closing the position:</b>		
Notional Transaction Value	1,000 x £21.50	21,500
Commission on the trade	£21,500 x 0.10%	21.50
<b>Profit / Loss:</b>		
Profit on trade	£21,500 - £20,000	1,500
Total Cost	£20.00 + £22.22 + £21.50	63.72
<b>Total Profit</b>	<b>£1,500 - £63.72</b>	<b>1,436.28</b>



## Buying a Stock CFD - Taking a SHORT Position

When you expect the price of a stock to go down, you can choose to take a short position in a single stock CFD.

In this example, you expect the share price of Company XYZ to fall from its current price of **£20.00**. You have £10,000 to place on margin. Since there is 20:1 leverage available on this instrument, you only have to place 5% of the trade amount on margin.

You decide to sell 1,000 CFDs at the offer price of £20.00, which gives you a position of (1,000\*£20.00) £20,000 in notional value.

Each day you hold the short position open, you pay a financing cost on the notional opening value of the position. You also pay borrowing costs.

The interest rate used is LIBID - Mark-down (0.40%-3.0% = -2.60%). Since the interest rate is negative, you effectively have to pay overnight financing at a cost of 2.60%.

10 days later, the price of Company XYZ has fallen and you buy the 1,000 CFDs back at **£18.50**.

Transaction	Transaction	Transaction (GBP)
<b>Opening the position:</b>		
Margin available	£10,000	10,000.00
Notional Transaction Value	1,000 x £20.00	20,000.00
Margin used	£20,000 x 5%	1,000.00
Commissions on the trade	£20,000 x 0.10%	20.00
Stamp Duty	-	n/a
<b>Financing of position:</b>		
Financing of margin	2.60% x 10 days x £20,000 / 360	14.44
Borrowing costs	1.00% x 10 days x £20,000 / 360	5.56
<b>Closing the position:</b>		
Notional Transaction Value	1,000 x £18.50	18,500.00
Commission on the trade	£18,500 x 0.10%	18.50
<b>Profit / Loss:</b>		
Profit on trade	£20,000 - £18,500	1,500.00
Total Cost	£20.00 + £14.44 + £5.56 + £18.50	58.50
<b>Total Profit</b>	<b>£1,500 - £58.50</b>	<b>1,441.50</b>



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